

Regulating the cryptocurrency markets

Chris Skinner, 16 Feb 2018 -

Opinion, Regulation, Risk Management

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How do you regulate something that is completely decentralised and has no office? I struggle to find an answer for this. I know that when my exchange is hacked or my hard wallet is lost, I am frustrated and have no authority to report it to or bail me out. What is the answer?

Luckily, I got a very good insight into this space from Alex Larsen of the Institute of Risk Management (IRM), who



wrote a lengthy piece about how he sees regulating the cryptocurrency markets. Here's what he has to say:

Regulating the cryptocurrency markets

According to Reuters: "Japan's financial regulator said on Friday it had ordered all cryptocurrency exchanges to submit a report on their system risk management, following the hacking of over half a billion dollars of digital money from Coincheck."

Whilst the whole premise of blockchain technology and cryptocurrencies revolves around it being essentially unhackable, the exchanges that trade these currencies are vulnerable. The introduction of system risk management (which we assume to be risk management of the software/operating systems and servers) checks is a step forward for the cryptocurrency space although it only covers one area of exposure linked to the cryptocurrency market.

History of incidents

Cryptocurrency has been a booming market with increases in some major coins in the high 1000's of percent over the last year. This rise, coupled with a lack of regulation, has seen the cryptocurrency world being hit with a number of negative incidents from Ponzi schemes to fraud, scams and hacking incidents.

Bitconnect, which as of writing of this article, is trading at roughly \$8.60, a huge fall from its height of over \$300 a month ago, is an example of a potential major Ponzi scheme which has lost \$2.4 billion worth of value over 10 days.

The subpoena by US regulators of crypto exchange Bitfinex and its relationship with Tether is another concern to the cryptocurrency market with many claiming Tether to be a scam. Tethers are tokens backed by US dollar deposits. with each tether always worth one



thus far the company has yet to provide evidence of its holdings to the public and has not had any successful audits as of yet.

There have also been a large number of Initial Coin Offerings (ICO's), used to raise money for startups by issuing tokens/coins, which have raised vast sums of money only for the owners to disappear with all the money, whilst others have been less deliberate but have been just as devastating to investors. A cryptocurrency called Tezos, raised \$232 million last year, but suffered internal power struggles which has left the project in disarray.

This brings us to the current concern in Japan of cyberattacks of exchange platforms. Cyberattacks and hacking attempts of exchanges have been frequent with Bitfinex, Coinbase and Kraken amongst others having been closed down for days at a time during 2017 due to a number of hacking attempts. It is the successful hacking incidents which are the most worrying however, with successful hacks such as MT Gox, which cost almost 350 million and two attacks on Youbit which led to its bankruptcy. The most recent Coincheck hacking was worth 500 million, a record, and it is this which has caused Japan to act.

Regulation

Last year, China took a definitive stand on regulation on cryptocurrencies which sent shockwaves through the market. Some feel it was perhaps heavy handed with ICO's being banned, bank accounts being frozen, bitcoin miners being kicked out and nationwide banning on the internet of cryptocurrency trading related sites. Others however believe that it has been a positive step, and has encouraged other governments to take regulation seriously and hopefully take a more balanced approach. It certainly isn't in the interest of governments to stop ICO's, which provide many positives including innovation,

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but they should certainly regulate them from a consumer protection, taxation and organised crime standpoint.

Implementing regulation also removes uncertainty for investors as well as the companies who are involved in ICO's. Uncertainty is the source of many risks and often a negative certainty is better than uncertainty as it allows a focus within set parameters.

It's important to remember that too little regulation doesn't offer protection and too much stifles innovation.

How to regulate

There are a number of ways to regulate cryptocurrencies and the following are just some examples:

1) Framework for ICOs

New ICO's are currently not subject to much in terms of regulation globally. One of the problems is determining how they should be treated with some being considered securities. As a fund raising vehicle, there could certainly be a framework that lays out key requirements of an ICO such as a company needing to be registered in order to issue a token, transparency in terms of individual members of the registered company as well as perhaps introducing a few requirements that regular IPO's require such as implementing risk management. Currently in USA, ICOs are expected to adhere to Anti Money Laundering (AML)/Know Your Customer (KYC) practices.

2) Regulate exchanges

Exchanges, which is where much of the transactions take place in terms of trading coins, is a logical area of focus when it comes to regulations

South Korea's financial services commission for example, has stated that trading of cryptocurrencies can only occur from real-name bank accounts. This ensures KYC

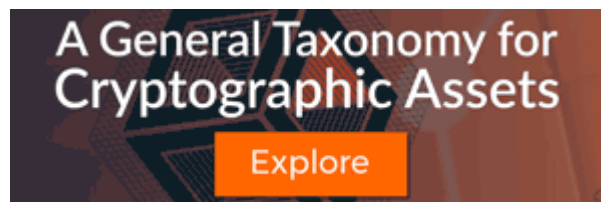


outlined were intended to “reduce room for cryptocurrency transactions to be exploited for illegal activities, such as crimes, money laundering and tax evasion,”

Regulators should focus on regulation that encourages transparency and minimises anonymity.

1) *Tax Laws*

Clarity needs to be brought into the tax laws in terms of when investors should pay capital gains. The USA has been quite quick to ensure that crypto-to-crypto transactions are now taxable and not just crypto to Fiat currency transactions. This is not the case in the UK however, where things are less clear and will become even more so, once cryptocurrencies start to introduce dividend like behaviour.



2) *Reserve requirements of exchanges*

Most banks and stock exchanges are required to hold a certain amount in reserves in order to survive any major downturn or crash. This should most certainly be the case for cryptocurrency exchanges too especially considering the volatility which sees crashes of 60% several times a year with some cryptocurrencies falling 90% before recovering. This is also known in part as systemic risk which could be what the Japanese financial regulator defines as system risk.

3) *System risk management*

As we have seen from this Japan story, one way of ensuring more protection and reliability is by ensuring there is regulation around system risk management on exchanges. There should be minimum requirements protecting against hacking, phishing and other cyber related attacks. The requirements could be scaled against value of the exchange, number of users or number of daily transactions.



It's important to note that much is being done to reduce the risks of hacking incidents such as the concept of a decentralised exchange. This would essentially be a cryptocurrency exchange on the blockchain, much like the cryptocurrencies themselves. This would reduce hacking significantly and whilst it is not currently practical, it could be the standard of the future.

Self-Regulation

The cryptocurrency market gets a lot of negative publicity and much of this could be rectified if there was more self-regulation. It would also reduce volatility within the market and bring about positive change. This refers to both exchanges and ICO's alike.

The Japan Blockchain Association (JBA) for example has established self-regulation standards which includes the use of cold wallets amongst its 15 crypto exchange members (of which Coincheck was one of them) and are now looking to strengthen the standards further following this recent incident.

Risk Management in the Cryptocurrency Space

Risk Management, as with all organisation's, plays a vital role in meeting and exceeding objectives whilst providing resilience and stakeholder confidence. Exchanges and companies that are raising/have raised ICO's should ensure that Risk Management is part of their business. Identifying risks and opportunities, assessing them and implementing response plans should be standard. Cyber risks, reputational risks, operational risks, system risks and strategic risks should all be considered and prepared for, which would minimise market disruption and reduce the likelihood of financial ruin. At the very least they owe it to the investors who have funded them.

For investors, with volatility so high, the rewards are great but so are the risks. Investors should ensure that they only invest what they can afford to lose, do their

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due diligence on their investments which includes understanding the technology, the team and look for a prototype rather than a wild concept. Additionally, investors should always be on the lookout for phishing scams and suspicious emails.

Finally, even the most optimistic investor should at least consider that cryptocurrencies are a speculative bubble that could burst.

If you agree or disagree with Alex's views, you can contact him al@baldwinglobal.com or via twitter [@AlexLarsen_Risk](https://twitter.com/AlexLarsen_Risk)



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Is the term 'Decentralized
Exchange' an oxymoron?

Cryptocurrency volatility: Why the risk-reward tradeoff is skewed

Lama Kanj, 10 Feb 2018 -[Cryptocurrency, Investment](#)

Cryptographic assets are one of the most — if not the



of money or lose everything. While for many the possibility of generating spectacular returns is the key attraction of crypto, are the risks consummate with the potential rewards?

In an effort to answer this question, this article explores the risk-reward profiles of a couple of different types of cryptographic assets. The first being Initial Coin Offerings (ICOs) and the second being existing coins and tokens.

Initial Coin Offerings

An ICO refers to the process of raising funds for early-stage crypto projects, in return for an issuance of a newly-created, native token. ICOs are an exciting category within the crypto sphere, with the potential to generate very high returns. A [report from Mangrove Capital Partners](#), for example, found that the average returns across 200 surveyed ICOs in 2017 was an astonishing 1,320 percent.

Naturally, though, ICOs come with a higher risk profile than existing, tradeable coins in the market, just like how penny stocks are riskier when compared to the stocks of blue-chip (established) corporations. The reasons are many, but the main ones are the fact that a majority of ICOs do not have a working protocol or product at the outset, with only a theoretical conceptualization of their project as manifested in their white paper.

For investors, therefore, it is vital to understand that there exists a high statistical probability of failure in the crypto start-up world. In addition to this, there is also the issue of the absence of [regulatory oversight towards ICOs](#), which translates into the non-existence of consumer-protection laws in the crypto asset space.

Existing coins and tokens

There are more than 1,500 [coins and tokens](#) currently being traded on exchanges. Under [the BNC General](#)

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be segregated into different categories based on their applications and the variety of use-cases they were intended for.

The risk profile of existing cryptographic assets is lower than that of ICOs for the simple reason that they have some history. Thus, investors can track the progression of the projects, whether they've met their deliverables and achieved the milestones set in their whitepapers. Time will tell if the technology and applications of a project are viable, and this will be reflected in its price. Besides the obvious volatility risks, the operational risks of securing cryptographic assets safely is a major point of concern especially as the masses are not really 'tech-inclined' when it comes to crypto, and the learning curve is relatively steep.

Overall, crypto assets are high-risk investments and the recent correction is a testament to that. The entire crypto market has decreased by more than 60% so far in 2018 from its December 2017 highs. However, looking beyond the short-term oscillations, there are some fundamental reasons as to why the volatility and risks appear as they do.

Ultimately, it's a new technology

It has been well documented that the inception of revolutionary technologies — such as the internet — often entails initial periods of volatility, as the industry is immature and adoption is limited. Blockchain, the technology underpinning Bitcoin and a majority of other cryptocurrencies, has the potential to disrupt a number of industries and bring positive changes on a global scale, advancing the principles of transparency, efficiency and accountability.

The fact that Blockchain technology has been around for more than 10 years with no fundamental flaws, an exponentially growing list of applications, and a dynamic



ecosystem that is constantly pushing the technological limits is a testament to its potential.

Utility leads to adoption

In order to achieve widespread adoption, crypto projects must offer viable solutions to real-world problems and thus warrant their usage. This is manifested in the utility — or uses-cases — of cryptographic assets. Using Bitcoin as an example, its dominant utility as a peer-to-peer medium of exchange is that it allows users to circumvent excessive banking (or any third party) fees and significantly reduce transaction times (although in reality, this utility has faced challenges in recent times as the Bitcoin network has attempted to scale transactions).

So essentially, Bitcoin allows users to engage in a global transfer of value at a fraction of the traditional cost and time. A greater rate of adoption will mean higher Bitcoin prices, due to increasing demand. Having a strong utility is therefore vital in substantiating the value of cryptocurrencies, and will ultimately benefit long-term investors.

The importance of due diligence

It is interesting to note that a **recent study** found that the cryptocurrency market is mainly driven by investor sentiment, and this leads to high levels of volatility. In addition, the technical nature of cryptographic projects makes it hard for many to understand them.

However, performing **due diligence** is a vital requirement in the investing process to ensure that one invests in cryptocurrencies that are fundamentally strong and possess long-term viability. Investing in good projects will significantly reduce your risk profile, assuming you're in it for the long-term.

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